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How to Improve Public Sector Finances in Honduras

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The Honduran government should develop a plan to modernize administration of the public sector, increase public sector savings, ensure the financial viability of the national electric company, and improve the public investment program.

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The objectives of a public sector management program should be to use resources more efficiently, rationalize public sector operations, and reduce financial disequilibrium.

Baran recommends that Honduran authorities prepare an action plan for improving public sector management. That plan should include measures to:

• Increase savings.

• Introduce efficiency-saving measures.

• Improve budgeting, debt management, and tax collection.

• Standardize accounting practices and properly account for debt service obligations.

• Start external management audits of enterprises.

• Establish financial targets for, and reduce government transfers to, public enterprises.

• Improve service delivery.

• Implement a well-defined privatization program.

• Prepare and implement a growth-oriented and financially feasible public investment program.

• Improve decisionmaking and increase accountability and autonomy in public enterprises.

• Improve coordination of the sector.

• Target subsidies.

• Produce better financial information on the public sector.

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I. INTRODUCTION

1. This Memorandum presents a comprehensive policy program to improve public finances in Honduras.[1] In view of the administrative limitations, the implementation of the proposed program would need to be phased over time and a timetable has to be developed for its execution. This report does not propose a timetable for execution of the proposed program, but recommends that such a program be developed in a follow-up report. The report presents both a short-term action plan to reduce the public sector deficit as well as a medium-term program to improve public finances. The report discusses issues and makes suggestions regarding taxes, expenditures, including the public investment program, and major public sector enterprises.

A. Background

2. Honduras is a poor country. Its per capita income is the second lowest in the Western Hemisphere and very close to subsistence levels. Malnutrition is severe. The literacy rate is less than 60%. About half the population is without safe water and three quarters of the households are without access to sanitary waste facilities and electricity.

3. The country has also been facing a major external and internal macro disequilibria since 1980. The deficit in the current account of the balance of payments and the Central Government finances reached about 10% of GDP until 1985. With the completion of the El Cajon hydro-electric project, the overall public sector deficit fell in 1987 to 5% of GDP on a cash basis. Public savings amounted to only 0.4% of GDP. Large USAID transfers and disbursements for the El Cajon project financed a large part of the deficits in the public sector as well as the current account of the balance of payments until the last several years.

4. The macro disequilibria worsened in 1987. With external financing tied to El Cajon no longer available and net external transfers abroad averaging 2% of GDP, monetary aggregates grew substantially. The monetary expansion put severe pressure on the domestic price level. The expansionary monetary growth, in turn, began to threaten the fixed exchange rate and domestic inflation--kept at very low levels in the past--started to rise, albeit still at a relatively low level of 3-4.5% p.a.

5. In the absence of a substantial further reduction in the public sector deficit, it is highly unlikely that domestic inflation could be kept to historically low levels. Hence, the maintenance of present policies implies an increased public sector deficit, higher domestic inflation, an enlarged deficit in the current account of the balance of payments and a likely default on external debt obligations. The resulting financial disequilibrium will likely have an adverse effect on domestic economic activity. Furthermore, mounting pressures on the official exchange rate will likely make it virtually impossible to keep the official nominal

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1/ Public Sector includes the Central Government, public enterprises and municipalities.

exchange rate constant. Since the political costs under this scenario (i.e. owing to high inflation, lower economic activity and high unemployment) will be large, the authorities would likely be tempted to take corrective actions.

B. Impact of Macro Developments on Public Sector Finances

6. There is a close association among the macro framework and public sector finances. Macro developments would have an impact on public finances and similarly corrective fiscal measures would have repercussions on macro developments. This report assumes that the authorities introduce a medium-term program to raise economic growth and maintain financial stability.

7. Under one scenario with adjustment measures, favorable macro developments will likely tend to expand public sector savings. High growth in GDP and the recovery of trade volumes would lead to increased public revenues while low domestic inflation would likely reduce the pressure on raising public expenditures.

8. Under the case without adjustment measures, however, macro developments would likely lead to a decrease in public sector savings. Low economic activity and reduced trade volumes would result in a decline of public revenues, while increased domestic inflation would lead to increased pressures on the authorities to expand public programs as a countercyclical tool.

II. PUBLIC SECTOR FINANCES

9. To confront the issues in public sector finances, the authorities need to define a medium-term program. These actions would be aimed at correcting the present financial disequilibrium as well as addressing public sector management issues. The elements of a proposed program in public finances are described in each section, following a discussion of issues in the sector. The goals of such a program could include:

(i) increasing mobilization of fiscal resources;
(ii) allocating public resources to high priority uses (i.e. both current and capital expenditures);
(iii) eliminating financial disequilibrium, and
(iv) improving the efficiency of the provision of services.

A. The Tax System

10. The tax system in Honduras is characterized by a dependence on indirect and mainly on trade related taxes (Table 1). Some taxes have specific rates and hence, their base has been eroded through accumulated domestic inflation over the years. Dependence on trade taxes increases the vulnerability of the system to exogenous price swings, leading to fiscal problems as terms of trade deteriorate. The existence of a large number of exemptions also leads to losses of fiscal revenues. As a result, the tax ratio rose only by 0.9 percentage points of GDP in five years to 13.7% in 1987. This ratio is not high compared to countries at Honduras's level of development.

Table 1: Central Government Current Revenues, 1982-87
(Millions of t) 1/

	1982	1983	1984	1985	1986	1987 1/
Tax Revenues	715.4	711.0	881.3	985.9	997.1	1,097.1
Direct Taxes	206.2	197.3	241.9	249.4	258.5	297.1
Income Tax	198.8	190.3	233.9	240.6	250.2	286.7
Property Tax	7.4	7.0	8.0	8.8	8.3	10.4
Indirect Taxes	509.2	513.7	639.4	736.5	738.6	800.0
Taxes on Domestic Transactions	230.1	223.1	284.7	320.6	328.2	353.6
Tax on production, consumption and sales	211.3	205.7	249.9	273.1	285.5	301.3
Beer	35.9	35.0	43.8	47.7	47.7	50.9
Soft Drinks	10.4	10.1	11.2	12.3	13.1	16.3
Liquors	26.1	28.5	26.3	28.6	28.9	27.2
Petroleum Products	14.6	16.2	17.0	17.0	17.7	19.9
Cigarettes	31.2	26.1	31.8	33.2	33.7	33.6
Sales Tax	91.5	87.2	116.0	129.2	134.9	146.4
Other Consumption Taxes	1.6	2.6	3.8	5.1	6.5	7.0
Others	18.8	20.4	34.8	47.5	45.7	52.3
Taxes on International Transactions	279.1	287.6	354.7	415.9	410.4	446.4
Imports	178.2	201.5	258.8	316.6	301.1	337.4
Exports	93.2	77.8	87.3	92.5	103.4	100.0
Bananas	45.4	34.9	36.8	41.3	36.1	39.6
Coffee	40.8	35.3	42.8	45.3	62.6	52.6
Others	7.0	7.6	7.7	5.9	4.7	7.8
Others	7.7	8.3	8.6	6.8	5.9	9.0
Non-Tax Revenues	54.7	67.1	68.3	78.2	154.6	171.2
Services	10.2	14.2	16.4	14.6	16.1	15.0
Transfers from rest of the Public Sector	17.0	[illegible]	17.3	18.2	18.5	17.1
Government Fees, Other Services	6.7	6.5	7.3	6.3	6.4	6.5
Other Income	11.9	24.2	15.4	21.9	105.3	132.6
Petroleum	(-)	(12.4)	(6.7)	(11.1)	(90.1)	(120.7)
Others	(11.9)	(11.8)	(8.7)	(10.8)	(15.2)	(11.9)
Other Non-Tax Revenues	8.9	7.2	11.9	17.2	8.3	-
CURRENT REVENUES	770.1	778.1	949.6	1,064.1	1,151.7	1,268.3

Source: Ministry of Finance, Bank Staff Estimates.

1/ t = lempiras

A.1. Income Tax

11. The income tax generates about one-fourth of total tax revenues. This tax has a large number of exemptions. The collection effort for the income tax has been very weak. The maximum marginal rate is 40% for incomes, exceeding L 10 million (L = lempiras, US$1 = L 2).

12. Conclusions. In the short-term, the collection effort has to be intensified, but existing rates should not be increased to avoid a recessionary impact.

A.2. Property Taxes

13. Collection from this tax has been limited, averaging only 0.8% of total Central Government current revenues in 1987. The tax suffers from outdated valuations, the absence of forceful enforcement and the lack of a cadaster.

14. Conclusions. In view of the lack of a cadaster and of up-to-date valuations, collections can not be expected to increase substantially in the short-term. However, for the longer-term, it is suggested that the Government prepare a cadaster and update valuations with a view to increasing collections.

A.3. Sales Tax

15. The sales tax is levied on both domestic and imported goods at a flat 5% rate--except for tobacco, which is taxed at 10%. The tax is mostly evaded by store owners, who generally collect the tax from customers but do not pay the Treasury. A 5% tax rate should provide sufficient incentives to intensify collection efforts. However, consideration has to be given to increasing the rate to 7% or perhaps 10% to reduce projected fiscal deficits to sustainable levels in the next several years. Compared to other developing countries, the rate of the tax is low (Table 2). It also has a number of exemptions. Moreover, the Government may set the tax on the basis of the physical characteristics of the establishments that are indicative of their sales volume (e.g. size of store, number of employees). Collection for this tax has averaged less than 2% of GDP or about 12% of Central Government current revenues in the recent past. This compares unfavorably with other developing countries.

Table 2: Rate of Value Added Taxes[1] by Selected Countries[2], 1987

Countries	%
Haiti	10.0
Grenada	20.0
Peru	18.0
Bolivia	10.0
Chile	30.0
Brazil	16.0
Indonesia	10.0
Madagascar	15.0

Source: IMF.

1/ Value added tax or a sales tax.

2/ Only those countries with a single rate are included in the table.

16. Conclusion. It is suggested that the authorities consider increasing the rate of this tax. Depending on the rate of increase--which could vary within a range of 2% to 5%--collection for this tax would provide a significant level of revenues. Coupled with an improved tax collection effort, this source could generate a major share of the needed revenues to reduce the fiscal deficit. For the longer-term, it is suggested that the authorities convert this tax into a value added tax, which could provide additional incentives for the private sector to comply.

A.4. Excise Taxes

17. These taxes are confined to a small number of commodities, including: beer, soft drinks, liquors, petroleum products and cigarettes. Their rates are mostly specific. With increased domestic inflation, collections from these taxes fell from 2.1% of GDP in 1982 to 1.8% in 1987.

18. Conclusion. It is suggested to convert the outdated excise taxes into selective consumption taxes at ad-valorem rates. Luxury items could be subject to higher rates. The product coverage of the tax could also be expanded. The rates under this tax should be the same for goods of both domestic and imported origin. The determination of rates under this tax should also be coordinated closely with suggested changes in import tariffs. Rates could be differentiated within a range. It is suggested not to introduce very high rates, as these might lead to increased evasion. However, cars could be taxed at high rates to reduce import demand and to generate fiscal revenues.

A.5. Taxes on Imports

19. A large share of taxes is collected from taxes on imports. Between 1982-87, taxes on imports rose, reflecting the increase in the value of imports and the introduction in 1984 of the 5% customs fee. As a result, the effective import tax rose from 12% in 1983 to about 16% in 1986.

20. Honduras has a complicated system of tariffs and surcharges, with a combination of taxes and surcharges levied on imports. A substantial portion of revenues from imports is derived from surcharges. In 1985, for example, revenues from import tariffs amounted to ₺80 million, while those from surcharges equaled ₺221 million.

21. Import tariffs were modified in 1987 in line with the changes introduced to the Central American Common Market (CACM) tariff system. As a result, all specific rates were eliminated, with rates converted into an ad-valorem basis, and the nomenclature was changed from the Central American classification scheme into that of Brussels. The following table presents the parameters for the new tariff regime:

Table 3: Parameters for the New Tariff Regime, 1987

Items	Rates
Inputs	1% 1/
Inputs for agricultural products	5%
Capital goods	5%
Final consumer goods 2/	50% - 90%

1/ Minimum rate.
2/ Medicine and some other health products are taxed at 1%.

Source: Ministry of Finance.

22. The tariffs range between 1% - 90%. High rates are applied for shoes, garments and few other final consumer goods--for which there is domestic production. Furthermore, more than one rate applies to some products depending on their end-use.

23. Three decrees define surcharges, which are levied on a CIF basis. They provide high and dispersed nominal and hence effective protection to the industrial sector. With surcharges, the maximum tariff rate equals 125%. The following table indicates the different rates of surcharges and the decrees which provide the legal framework for those charges:

Table 4: Rates of Surcharges, 1988

Decree No.	Items	%
Decree No. 54	Inputs	5.0
	Final consumer products	10.0
Decree No. 85/4	All products	10.0
Decree No. 59	All products	20.0

Source: Ministry of Finance.

24. Collections from imports are reduced, however, owing to the existence of a large number of exemptions. Over 40 laws regulate the granting of exemptions under imports. As a result, only about one-fourth of imports are subject to tariffs, leading to a fiscal revenue loss of about 2% of GDP annually. About one-quarter of imports generate virtually all revenues from imports. The exemptions increase the level of effective protection for industry and raise variability in both nominal and in effective protection.

25. A large number of products and institutions are exempted from the payment of import duties. These include: agriculture inputs, public

sector imports, and inputs for various industries. Exemptions granted to public sector imports account for about one-fifth of all exemptions, and public sector enterprises account for about two-thirds of the exemptions granted to the public sector.

Conclusions

26. Rationalization of the tariff regime will likely take time. At present, the main objective of the import regime is to generate government revenues, while dampening import demand and protecting the domestic industry. It is desirable that at the final stage of the reform process, the parameters of the tariff structure resemble the targets which the other Central American Common Market (CACM) members aim at achieving in the medium-term. In this context, a maximum and unified tariff rate of 20% should be the long-term goal.

27. As a first step, however, it is suggested to phase out quantitative import restrictions on imports and replace them with tariffs. At a fixed exchange rate, nominal tariffs would need to be raised to avoid a sharp increase in imports. Under a flexible exchange rate policy, the exchange rate needs to be depreciated in real terms. However, if the Government does not introduce a compensatory devaluation, then the process of tariff liberalization has to be slowed down. Given that the tariff equivalent of quantitative restrictions is difficult to estimate, there is a danger that the higher tariffs are not subsequently reduced following the substitution of quantitative restrictions by tariffs. To avoid this scenario from happening, the Government needs to define its medium-term goal of reducing tariffs over time. Secondly, it is suggested that a process be started to phase out exemptions on import tariffs.

28. The first stage of the reform process should attempt to rationalize the tariff system by making it more transparent as well as to generate higher levels of government revenues both through a reduction in exemptions as well as a conversion of quantitative import restrictions into tariffs. It would not, however, reduce effective protection. The first stage of the reform would be consistent with the need to establish macro-financial stability and control import demand.

29. The later stages of the tariff reform should aim at initially phasing out import surcharges and then reducing high tariff rates. Given the small and limited size of the private sector in Honduras, and consequently likely slow adjustment of the private sector to the changing signals in the economy, the adjustment of the tariff regime will need to be a slow process. Furthermore, changes in the tariff regime would need to be coordinated with exchange rate policy. Hence, those changes should be introduced after macro-financial stability is established. Otherwise, attempting to do too much in one step would likely raise social and political costs and would not likely be sustainable. Obviously, tariffs can be reduced substantially if the exchange rate is devalued at the same time. This will also provide incentives to non-traditional exports.

30. Fiscal implications of changes in the tariff regime should be assessed and any expected shortfall in government revenues should be compensated for by additional public savings measures. The initial stage of the reform should not necessarily lead to a loss of revenues. However, the precise fiscal impact of subsequent steps of the reform is not yet

certain. To the extent that further trade liberalization is carried out through increasing low tariffs and phasing out exemptions, declines in high tariff rates should not necessarily lead to a loss of revenues. However, if subsequent stages of the reform fail to increase low tariff rates or to phase out exemptions, there will likely be a net loss in government revenues. It is suggested, therefore, that any reduction in tariff revenues owing to reduced rates--assuming that the effect of the increased import volume will not change the final outcome--should be compensated for by additional savings measures. Public savings could be enhanced by raising collection from sales tax through strengthening collection effort and raising the rate of the sales tax from 5% to 7% or perhaps to 10%.

A.6. Export Taxes

31. About a tenth of tax revenues was derived from export taxation during 1982-87. Virtually all of the collection from export taxes is obtained from coffee and bananas. These taxes can be considered quasi-income taxes on coffee and banana farmers since income taxes collected from plantations growing these two crops are low.

32. The authorities modified the tax on coffee in 1988, reducing the minimum international price below which exports of coffee will not be taxable. The minimum taxable price was set at US$1.20 per pound. If the international price drops below US$1.20, the revenues will likely drop by about ₡50-60 million (i.e., US$25-30 million) a year.

33. Conclusion. In view of the need to maintain revenues from coffee exports, it is suggested to lower the minimum price limit on coffee exports. For the medium-term, it is important to restructure the coffee export tax along the lines of the Costa Rican coffee export tax, which has a graduated rate structure, with higher international prices taxed at higher rates, enabling the Government to benefit from windfall gains.

A.7. Petroleum Differential Tax

34. The Government taxes petroleum products through a petroleum price differential tax. This tax is levied on the difference between the domestic and international price of petroleum in domestic currency. As the international price of oil dropped sharply in 1986, domestic prices were not reduced, thus leading to a significant increase in collection of this tax, which rose from ₡11.5 million (US$5.8 million) in 1985 to ₡90.1 million (US$45 million) in 1986.

35. Conclusion. The authorities expect to collect about ₡100-120 million from this source in 1988/89. In the short-term, it is suggested not to reduce domestic petroleum prices to generate government revenues as well as to encourage fuel savings. Furthermore, continuous changes in domestic prices are not politically feasible. Moreover, the large dependence of Government revenues on this volatile source (i.e. this tax generated about 8.5% of current Central Government revenues in 1987) underscores the need to undertake a tax reform, aimed principally at shifting the burden of taxation from international trade to domestic sources (i.e. see Working Paper on "Harmonizing Taxes in Central America" for a more detailed analysis).

A.8. Tax Administration

36. The authorities believe that there is a high degree of evasion of all taxes owing mostly to weak administration and to the limited number of contributors under the income and domestic transaction taxes. Of the total population of about 4.2 million in Honduras, there are only 160,000 contributors, of which less than half actually pay their income taxes. It is further believed that a large number of stores collect domestic transaction taxes (i.e. sales and excise taxes), but they do not report these collections to the Government. The lack of sufficient logistical support (i.e. computers) also hinders effective monitoring.

37. Conclusion. It is suggested to intensify efforts at tax collection, and mainly on those taxes which could generate large collections such as income and sales taxes. USAID is assisting the Government in tightening tax collection procedures. However, efforts need to be intensified on the following areas:

(i) improving taxpayer identification (the major thrust of the effort should be on better monitoring of large producers, importers and corporations);
(ii) increasing the number of tax-payers; and
(iii) providing better logistical support to tax administration in the Ministry of Finance.

A.9. Customs

38. The authorities believe that there is a high degree of evasion of custom duties. The main factors behind this evasion are believed to include: (i) the lack of sufficient training of the officials at the ports and customs, especially regarding valuation of items; (ii) the lack of adequate logistical support such as equipment, labs etc; and (iii) the existence of bribery. To address these issues, it is suggested that technical assistance be extended to the Government to provide training, logistical support and to strengthen monitoring of customs.

A.10. Overall Conclusions on the Tax System

39. Rationalization and modernization of the tax system is urgently needed. Toward this end, the authorities need to focus on increasing the mobilization of fiscal resources, changing the structure of taxes to make them more elastic to economic growth, reducing the vulnerability of the tax system to exogeneous price shocks and shifting the burden from income to domestic transaction taxes. In carrying out these reforms, there is a need for: (i) coordinating planned changes with the efforts under the trade reform; (ii) minimizing adverse effects on economic activity; (iii) simplifying the tax system; and (iv) reducing exemptions both under the corporate income tax as well as under imports.

40. Changes in the tax system will probably not be politically popular. First, Congressional approval of changes may prove to be difficult. Second, an increase in rates could encourage evasion. In fact, without strengthening the tax administration, it is possible that actual tax collections could decline following a rise in rates.

B. Central Government Expenditures

41. Central Government expenditures grew at about 10% a year during 1982-87. This growth masks the changing composition of expenditures, since capital expenditures (i.e. mostly transfers to ENEE) fell while current expenditures rose.

B.1. Introduction

42. The current structure of expenditures presents rigidities. As a result, the scope for decreasing expenditures within a possible adjustment program will likely be minor. For example, interest payments almost tripled in real terms during 1981-1987 and accounted for about 16% of current expenditures in 1987, while expenditures on defense equalled 7.8% of the total in 1987 (Table 5). It is generally believed that expenditures related to defense are distributed among various categories such as wages and salaries, debt service, investment, and goods and services. Total military expenditures are believed to have amounted to 23% of current revenues in 1987. Given the sensitive border problems, defense expenditures may prove to be difficult to reduce in the short-term. Furthermore, expenditures on the social sectors remained at one-third of the total during the period. This is mostly due to high education expenditures (i.e. mostly for teacher salaries). As a result, the share allocated to infrastructure, mostly for transport and natural resources which the country badly needs, declined over the years.

Table 5: Central Government Expenditures by Function, 1981-87
(% of total)

	1981	1982	1983	1984	1985	1986	1987 1/
Administrative Expenditures	20.0	17.0	16.6	17.4	19.9	14.7	14.6
Social Sectors	35.0	34.9	32.7	30.7	30.4	32.6	32.2
o/w Education	(20.2)	(21.2)	(19.7)	(19.7)	(20.1)	(20.8)	(20.8)
o/w Health	(11.2)	(10.6)	(10.4)	(11.0)	(8.3)	(9.8)	(9.6)
Infrastructure	16.2	13.7	12.6	10.3	9.1	11.3	10.6
o/w Transport and Communications	(9.0)	(7.3)	(6.8)	(5.7)	(4.8)	(5.6)	(5.8)
o/w Natural Resources	(7.2)	(6.4)	(5.8)	(4.6)	(4.3)	(5.7)	(4.8)
Defense	13.5	13.1	12.4	14.0	14.0	13.0	7.8
Debt Service 2/	15.3	21.4	25.7	27.6	26.6	28.4	34.8
	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance.

1/ Budgeted.
2/ Includes amortization payments. The] Ministry of Finance classifies amortization payments as expenditures and it was not possible at this time to differentiate interest from amortization payments in this table.

43. Conclusions. Any fiscal adjustment effort would need to aim at reducing the growth of the non-interest expenditures of the Central Government. This goal can be achieved through a decrease in the wage bill and transfers to public sector enterprises, economizing on expenditures on goods and services, and introducing cost-effective programs. In terms of functional distribution, further growth in military expenditures needs to be restrained. Reductions in the wage bill will likely require retiring personnel and revising wage policy. Both actions are likely to prove to be politically difficult to carry out. But, these actions are indispensable for achieving fiscal austerity. In this respect, the authorities should continue to implement the wage freeze for public employees and extend the freeze also to teachers and medical personnel. Obviously, politically strong unions could counteract these policies.

44. A large part of Central Government spending goes to wages and salaries, averaging about 45% of current expenditures and 7.7% of GDP during 1982-87. A significant share of wages and salaries are incurred in the education sector, accounting for about one-third of the public wage bill in 1986. The total wage bill grew as public employment jumped from 67,000 in 1982 to about 72,000 in 1986. About one-third of public employees were teachers in 1986.

45. Transfers also constitute a major source of Government outlays (Tables 6 and 7). A large part of these transfers go to public sector enterprises, averaging about 17% of total Central Government outlays and about 4% of GDP a year during 1984-87. Transfers to National Electricity Company (ENEE), National Water and Sewerage Service Company (SANAA), and National Agrarian Institute (INA) comprised a large share of those transfers over the last couple of years. El Cajon was the major recipient of capital transfers, while current transfers went mostly to the universities and INA.

Table 6: Central Government Current Transfers to the Rest of the Public Sector, 1984-86
(millions of L)

	1984	1985	1986
Public Sector Enterprises	89.3	105.9	123.5
INA	(25.4)	(30.6)	(31.9)
UNAH	(48.1)	(57.9)	(70.5)
JNBS	(9.1)	(10.4)	(13.2)
Municipalities	0.5	0.5	0.5
Others	12.9	30.8	31.2
Total Public Sector	102.7	137.2	155.2
Memorandum Item			
Total current transfers as a % of GDP	1.6	2.0	2.1

Source: Central Bank of Honduras.

Table 7: Central Government Capital Transfers to the Rest of the Public Sector, 1984-86

(millions of L)

	1984	1985	1986
Public Sector Enterprises	197.4	113.3	59.4
ENEE	(142.3)	(80.9)	(18.2)
INA	(13.2)	(4.0)	(12.5)
SANAA	(14.0)	(15.8)	(20.8)
HONDUTEL	(4.2)	(-)	(-)
INVA	(1.7)	(2.2)	(2.3)
IHMA	(9.3)	(6.5)	(-)
COHDEFOR	(-)	(2.0)	(3.6)
IHCAFE	(8.8)	(-)	(1.2)
Others	(3.9)	(1.9)	(0.8)
Municipalities	9.3	12.8	10.0
Others	-	2.0	3.6
Total Public Sector	206.7	128.1	73.0
Memorandum Item Total capital transfers as a % of GDP	3.3	2.0	1.0

Source: Central Bank of Honduras.

B.2. Education Expenditures

46. Education expenditures grew rapidly during 1981-86. About two-thirds of expenditures were spent on wages and salaries. While there has been a freeze on public sector wages over the last couple of years, teachers have consistently received salary increases well above domestic inflation each year. Investment expenditures for the sector, however, fell during this period.

47. Central Government transfers covered over 90% of the financial needs of the sector in the recent past, while user charges financed the rest. As financial resources devoted to investment contracted, the quality of education also suffered.

48. Regarding the allocation of expenditures by branches, almost half of the total goes to primary education, while 20% of the total is allocated to secondary education and the rest is spent on universities. Given the difficulties in raising user charges for primary and secondary education--which comprise about 90% of the expenditures spent in the sector--the scope for increasing savings through adjustments in user charges is limited.

49. Conclusions. Given the need to control expenditures and improve quality of education, savings could be generated by reducing the growth of salaries below domestic inflation if politically viable. Obviously, achieving macro stability would help moderate wage increases by reducing the underlying domestic inflation rate.

B.3. Health Expenditures

50. Central Government expenditures on health have absorbed about one-tenth of the total during 1982-87. In addition to the Central Government, the Social Security Institute (IHSS) also provides health services. The combined expenditures on health averaged 2.7% of GDP in 1987.

51. Conclusions. Given the poor social indicators in Honduras (i.e. high mortality rate and low life expectancy), reductions in health expenditures are not desirable. However, efforts should be expedited to make those expenditures more cost-effective, while ensuring improved coordination among the Central Government and IHSS.

C. Central Government Finances

52. After a deterioration during 1982-84, overall Central Government finances continued to improve during 1985-87 (Table 8). The fiscal deficit fell from an annual average of about 10.8% of GDP during 1982-84 to less than 8.2% during 1985-87. However, the deficit in 1987 on an accrual basis --at 7.3%--was still high. The improvement during 1982-87 reflects the effect of an increase in revenues by 2.3 percentage points of GDP to 16.1% and a reduction in overall expenditures by 0.5 percentage points of GDP to 23.4%. However, the decrease in expenditures as a share of GDP masks the changing composition of expenditures, since current expenditures grew by 3 percentage points of GDP to 18.5%, while capital expenditures fell by 3.5 percentage points of GDP to 4.9%. The sharp expansion in current expenditures resulted mainly from wage and salary increases as well as a raise in military outlays. As a result, Central Government current dissavings increased from 1.7% in 1982 of GDP to 2.4% in 1987. The reduced capital expenditures resulted not only from the termination of transfers to El Cajon as the project was completed, it also stemmed from a cutback in investments in transportation and agriculture.

Table 8: Central Government Finances, 1981-87
(% of GDP)

	1981	1982	1983	1984	1985	1986	1987
Current Revenues	14.0	13.8	13.6	15.5	16.2	15.6	16.1
Tax Revenues	13.1	12.8	12.0	14.0	14.7	13.2	13.7
Non-Tax Revenues	0.9	1.0	1.6	1.5	1.5	2.4	2.4
Current Expenditures	15.1	15.5	16.8	17.1	18.5	17.9	18.5
Current Account Balance	-1.1	-1.7	-3.2	-1.6	-2.3	-2.3	-2.4
Capital Expenditures and Net Lending	6.8	8.4	7.4	10.1	7.2	5.5	4.9
Overall Balance (accrual basis)	-7.9	-10.1	-10.6	-11.7	-9.5	-7.8	-7.3
Overall Balance (cash basis)	-7.9	-10.1	-10.6	-11.7	-9.5	-7.8	-6.7
Net External Financing	4.7	4.5	5.1	7.8	4.9	2.7	0.9
Foreign Assistance[1]	0.0	0.6	0.3	1.1	1.7	1.8	1.1
Net Domestic Financing	3.2	5.0	5.2	2.8	2.9	3.3	4.0
Bank credit	3.0	4.4	3.0	1.9	1.9	2.3	1.6
Bonds	0.6	0.8	1.5	1.4	0.5	1.0	1.7
Others	-0.4	-0.2	0.7	-0.5	0.5	0.0	0.7
Change in Arrears on amortization obligations	0.0	0.0	0.0	0.0	0.0	0.0	0.7

Source: Central Bank of Honduras, Ministry of Finance, IMF, Bank Staff Estimates.

1/ Mostly USAID grants.

D. Financing of the Central Government Deficit

53. As external assistance contracted, domestic sources of financing gained importance during 1984-87. Net external financing fell from a peak of 7.8% of GDP in 1984 to 0.9% in 1987, mostly as a result of reduced capital inflows. During this period, the domestic counterpart of USAID assistance provided financing of the fiscal deficit of an amount equal to an annual average of 1.4% of GDP. However, paralleling a reduction in project pipeline, net external financing decreased over the years. An expansion in the domestic sources financed a larger share of the deficit in the last few years.

54. Increased domestic financing of the fiscal deficit is risky, given its inflationary implications. Continued high levels of Central Bank advances to the Central Government will likely fuel domestic inflation and could start an inflation-devaluation spiral in a country which maintained fixed exchange rate for over 60 years. Central Bank advances to the Central Government rose during 1986-1987. Of the total, almost half was provided with no interest and the remainder at subsidized interest rates. Central Bank advances to the Central Government were facilitated by high reserve requirements on commercial banks. Furthermore, treasury bond sales to the public and to commercial banks also accelerated. This increase was made possible by maintaining high interest rates on treasury bills, with rates on these bills ranging between 9% and 11% in 1987. As a result, the stock of domestic debt continued to expand (Table 9). If the rate of growth of debt is maintained at present levels, interest payments on the domestic debt would likely absorb a large share of Central Government revenues in the next few years.

Table 9: Debt Stock of the Public Sector, 1984-86
(millions of L)

	1984		1985		1986	
	Domestic	External	Domestic	External	Domestic	External
Central Government	1,599.4	2,273.2	1,837.9	2,615.8	2,033.5	2,878.5
Public Sector Institutions	840.9	647.1	929.7	810.2	988.9	902.2
Municipalities	223.8	12.2	230.2	10.4	248.1	9.2
Total	2,664.1	2,932.5	2,997.8	3,436.4	3,270.5	3,789.9
Memorandum Item						
Total as % of GDP	42.3	46.5	44.6	51.1	43.6	50.6

Source: Central Bank of Honduras.

55. As a result of liberal and excessive use of almost all possible sources of financing in the past few years, the Government has virtually exhausted all prudent forms of financing the fiscal deficit for the next several years. Regarding external financing of the deficit, USAID indicated that it will scale down its transfers in the future. Owing to the completion of the El Cajon hydro-project and the weak pipeline of projects by the multilateral agencies coupled with projected increase in amortization obligations on external debt, net external financing for the Central Government will be at reduced levels in the next several years. On the domestic side, further large expansions in Central Bank advances to the public sector will likely fuel domestic inflationary pressures (Table 10 shows the financing of the public sector by the domestic monetary system).

If Central Bank credit expansion is financed by increasing reserve requirements of the commercial banks, this could lead to reduced credit availability and higher domestic interest rates, and hence adversely affect economic activity. Excessive reliance on borrowing would unnecessarily raise interest payments in the future, and hence would result in a further increase in the public sector deficit. Hence, the deficit should be reduced to levels which could be prudently financed by net disbursements of external loans, mostly obtained at concessional terms. Based on IBRD projections, this level is projected at about 1.5%-2% of GDP for 1988-90. The reduction in deficit could be achieved through a combination of revenue increases and expenditure restraint. Specifically, raising tax collection effort, increasing public utility prices should provide the bulk of savings effort in the short-term. Obviously, any serious medium-term effort should focus on expenditure reductions through elimination of low-priority programs, divestiture of public enterprises and reduction of public employment.

Table 10: Banking System Financing of the Public Sector As End of Year, 1983-87

(millions of t)

	1983	1984	1985	1986	1987
Central Bank Credit:					
To Public Sector	619.9	650.9	698.3	622.8	751.3
To Central Government	530.6	576.9	622.5	628.7	721.3
To Rest of the Public Sector	89.3	74.0	75.8	34.1	30.0
Commercial Bank Credit:					
To Public Sector	349.8	405.9	387.2	491.8	537.9
To Central Government	371.2	449.2	517.6	676.7	691.1
To Rest of the Public Sector	-21.4	-43.3	-130.4	-184.9	-153.2

Source: IMF.

E. Budget for 1988

56. Table 11 indicates the budget for 1988. Essentially, this budget perpetuates the existing problems inherited from previous years. Congress introduced a large number of modifications to the proposed budget prepared by the Executive branch of the Government. These measures reduced the proposed budgetary allocations by about t153.0 million, or about 1.7% of GDP, with about two-thirds of it expected to be financed by external sources. Congress also changed the composition of proposed expenditures by increasing allocations for some programs, while scaling down others. For example, allocations for defense were increased from the proposed amounts, while some investments with concessional financing were reduced. Also

subject to cuts were some developmental investments such as those in natural resources and transport and allocations for the Office of the Presidency. The modifications clearly do not bring out any clear picture; they are likely to lead to difficulties in the implementation of the budget.

Table 11: Budgeted Expenditures by Sector, 1988

(% of Total)

	Percent
Administrative Expenditures	15.0
Social Sectors	32.0
o/w Education	(19.0)
o/w Health	(11.5)
Infrastructure	17.6
o/w Transport, Communications	(11.8)
o/w Natural Resources	(5.8)
Defense	7.0
Debt Service[1]	28.4
Total	100.0
In millions of t	2,168.6
Memorandum Item	
Total Budgeted Expenditures as % of GDP	25.0

Source: Ministry of Planning.

[1] Includes amortization payments.

The Budget Process

57. Before 1988, the budget for the Central Government was prepared by the Budget Office at the Ministry of Finance. In 1988, the budget was prepared by the Ministry of Planning in order to ensure consistency between current and capital expenditures of the Central Government.

58. The budget process is burdened with a number of issues. The budget for the Central Government is prepared on the basis of existing programs irrespective of whether there still continues to be a need for some of these programs. As a result, the budget process perpetuates the existing programs. What is worse, almost all programs are expected to grow each year, oftentimes exceeding domestic inflation rate, thus resulting in a real increase in expenditures in most programs. Within this framework, it is not possible to seriously attempt to reduce expenditures. Furthermore, since the expenditures of the rest of the public sector are not planned through a consolidated public sector budget, the Central Government does not have a powerful handle on controlling expenditures. As a result, the budgeting process has not been used as a macroeconomic tool to reduce expenditures to adjust them to reduced real available resources when terms of trade deteriorate. Additionally, budgets oftentimes failed to incorporate counterpart funds for ongoing projects, resulting in the unnecessary deceleration of ongoing public projects. Lastly, there are structural rigidities in the budget such as earmarking of 6% of revenues of the Central Government for universities.

59. Conclusions. The implementation of the following actions on the part of the Government would go a long way in rationalizing the budget process and transforming it to be a macro tool for adjusting expenditures as necessary:

- (i) involving the Ministry of Finance in the preparation of the budget to ensure an improved coordination among the Ministries of Planning and Finance;
- (ii) shifting to a zero-based budgeting system on most programs--to the extent possible--to enable the Government to delete or reduce low-priority programs from the budget;
- (iii) preparing a consolidated public sector budget to ensure a better planning of expenditures at the public sector level, rather than only at the Central Government level (i.e., this budget could initially cover the Central Government and a few major public enterprises such as ENEE, HONDUTEL (Honduras Telecommunications Company), SANAA, INA, and COHDEFOR (Honduras Forestry Development Corporation), but it could then be expanded to include most of the non-financial public sector);
- (iv) budgeting adequately for the counterpart funds for public projects to ensure timely implementation of public projects; and
- (v) ensuring a close monitoring of the efficiency with which earmarked funds are utilized by universities.

F. Public Investment Program

F.1. Public Investment Expenditures

60. Public investment expenditures averaged about 9.4% of GDP annually during 1981-87 (Table 12). After reaching levels of almost 12% of GDP during 1983-84, public investment expenditures fell to an annual average of 7.3% during 1986-87, following the completion of the El Cajon hydro-power

project. Expenditures on El Cajon accounted for about half of the total public investment expenditures during 1981-85. As a result, during 1981-85, over 70% of public investment expenditures were allocated to infrastructure, while 7% went to productive sectors and 23% to social sectors.

Table 12: Public Sector Investment Expenditures, 1981-87
(% of GDP)

	1981	1982	1983	1984	1985	1986	1987
Public Sector	9.0	9.8	11.5	11.9	9.1	7.1	7.5
o/w Public Sector Enterprises	(5.9)	(6.2)	(7.9)	(8.1)	(5.2)	(3.3)	(3.9)

Source: Ministry of Planning.

F.2. Public Investment Program for 1987-90

61. The authorities prepared a proposed investment program for 1987-90. Based on Government projections, the proposed program aims at recovering the share of public investment expenditures to an annual average of 11% of GDP during 1988-90. To achieve this, the authorities plan to start a number of new projects during the proposed program period.

62. Table 13 shows the shares of the new and ongoing projects in the proposed investment program. As indicated in the table, about 70% of the proposed investment program would consist of new projects. The composition of the program would also change, with the productive (i.e. mostly in agriculture) and social sectors increasing their share of the total, while infrastructure's share falling.

Table 18: Planned Investment Program by Sector, Share of Ongoing and New Projects in Investment Program, 1987-90
(% of total)

	Ongoing Projects	New Projects	Total
I. Productive Sectors			
Agriculture	7.7	16.1	23.8
Agroindustry	0.7	0.6	1.3
Industry	2.7	1.0	3.7
Tourism	0.0	2.5	2.5
Forestry	0.0	0.8	0.8
Fishing	0.0	1.6	1.6
Mining	0.0	0.1	0.1
Sub-total	11.1	22.7	33.8
II. Infrastructure			
Transport	7.3	18.9	26.2
Energy	2.2	4.0	6.2
Communications	2.7	1.1	3.8
Urban Development	0.3	2.2	2.5
Sub-total	12.5	26.2	38.7
III. Social Sectors			
Health	5.4	15.6	21.0
Education	1.4	1.8	3.2
Housing	0.3	3.0	3.3
Sub-total	7.1	20.4	27.5
TOTAL	30.7	69.3	100.0

Source: Ministry of Planning.

Issues

63. Public investment programs have faced a number of issues during implementation in the past. These issues can be summarized as: (i) the lack of sufficient counterpart funds; (ii) the poor selection and screening of projects; (iii) the absence of utilizing economic efficiency criteria in the selection of public projects; and (iv) the poor supervision and monitoring of projects.

64. Conclusions. The size of the public investment program needs to be reduced to fit financial availabilities. Since some projects will not likely be implemented on schedule, the program would be underexecuted. However, the Government needs to define a doable program, which would allow recovery of public investment. To address issues regarding the preparation, execution and monitoring of public investment program, the implementation of the following actions would be useful: (i) introducing efficiency and other savings measures to generate sufficient counterpart funds for public projects, while obtaining additional external resources (i.e. from Japan, IDB, and USAID); (ii) improving selection and screening of projects; (iii) introducing the use of efficiency criteria to evaluate public investment projects; and (iv) improving the capacity of the Central Government in supervising and monitoring projects.

65. In terms of sectoral allocation of the public investment program for 1988-90, the following suggestions could be made:

(i) increase distribution and transmission of electricity;
(ii) give priority to projects in the social sectors (i.e. provision of water supply);
(iii) maintain transport infrastructure;
(iv) expand investments in natural resources;
(v) decelerate the pace of growth of telecommunication projects;
(vi) limit expenditures on railways to basic minimum maintenance; and
(vii) limit expenditures on ports to basic minimum maintenance.

F.3. The Institutional Framework for the Preparation of Public Investment Programs

66. The Ministry of Planning (SecPlan) is in charge of planning public investment programs. In carrying out this function, SecPlan does not utilize economic efficiency criteria, nor does it use cost-benefit analysis. As a result, the project screening and selection process has been very weak in the past. SecPlan has prepared another such plan for 1987-90. A review of the program indicated that the financing needed for the plan far exceeds the level of prudently projected public savings and realistically expected capital inflows during the period. Furthermore, the project selection was not based on economic efficiency criteria.

67. Conclusions. It is suggested that planning and screening of public investment projects be strengthened. To achieve this goal, technical assistance needs to be provided to SecPlan to enable it to put together a financially feasible and a growth-oriented public investment program, incorporating only thoroughly reviewed and screened projects, selected by using efficiency criteria. In this way, a three-year rolling plan could be prepared. The plan should be embedded in a macro-economic framework, which needs to take into account projections of at least five years into the future. In the short-term, however, it is suggested that the size of the program be reduced to the expected financial availabilities, taking into account the Government's priorities.

G. Public Sector Enterprises

68. There are a large number of public enterprises in Honduras. These include companies, such as utilities (i.e. electricity, telecommunications, and water), transport (i.e. railways, ports), public banks (i.e. both agriculture and industry), and agricultural marketing agencies.

G.1. Introduction

69. In 1987, the combined revenues of public sector enterprises accounted for about 40% total public sector revenues and their combined expenditures, 37% of total public sector expenditures. Investment outlays of these group of enterprises equalled 35% of total public sector investment.

70. The overall finances of this group of entities were in deficit during 1984-87 (Table 14). Their current savings averaged about 2.3% of GDP a year during the same period (Table 14). However, the deficit on their overall finances would have been much larger in the absence of transfers from the Central Government.

71. Public enterprises face a number of issues. These include: (i) the setting of tariff levels on the basis of political considerations rather than on efficiency criteria, and not adequately taking into account the financial needs of entities; (ii) Congressional approval of changes in tariffs and user charges, which make increases in rates very difficult; (iii) overstaffing in some enterprises (i.e. HONDUTEL); (iv) inadequate management practices such as the lack of long-term planning, cumbersome decision-making, the absence of assignments of responsibilities to managers; (v) the lack of adequate supervision and monitoring of financing of public enterprises by the Central Government; (vi) the engaging in activities outside the scope originally envisioned for some of the entities (such as COHDEFOR); (vii) inefficiency in operations; (viii) the lack of standard accounting procedures and the resulting lack of transparency in financial information; (ix) inappropriate decisions on past investments; (x) inadequate efforts to collect revenues (i.e. ENEE, HONDUTEL, SANAA); and (xii) labor problems.

72. The above-noted issues have led to a multitude of undesirable results. These include: (i) weak finances in most institutions; (ii) proliferation of a large number of enterprises without a clear mandate; (iii) price distortions; (iv) high capital-output ratios in investments; (v) inadequate statistical information, produced with a delay which makes it difficult to take policy decisions based on recent information; and (vi) dependence on Central Government transfers and external finance to fund their operations.

Table 14: Finances of Public Sector Enterprises, 1981-87

(% of GDP)

	1981	1982	1983	1984	1985	1986	1987
Current Savings	2.1	1.9	2.3	2.3	2.9	2.1	2.0
Overall Balance (-=deficit)	-4.8	-5.4	-6.5	-6.5	-2.7	-1.8	-2.3
Net External Financing	2.9	2.0	2.9	5.0	3.1	0.7	0.3

Source: Central Bank of Honduras.

73. The financial assessment of the performance of public sector enterprises is hampered by extensive non-market interventions such as price controls on outputs, as well as conversion of their debt into equity, implicit and explicit transfers received from the Central Government, assumption of external debt obligations of some enterprises by the Central Government and other implicit subsidies they receive from the rest of the public sector (i.e. non-repayment of telephone bills etc.). Interest subsidies and tax privileges also make it difficult to assess the actual financial performance of these enterprises.

Suggested Action Program

74. To address issues regarding public sector enterprises, a medium-term action program needs to be prepared and implemented. Such a program should include the following actions:

(i) increasing tariffs and user charges;
(ii) reducing expenditures;
(iii) introducing efficiency measures;
(iv) improving services;
(v) restructuring ENEE's external debt; and
(vi) privatizing and closing some enterprises.

75. Specific examples of an action program are illustrated below:

A) Reduction in expenditures:

a) Decrease in employment levels (HONDUTEL);
b) Introduction of efficiency measures with pre-established targets to increase efficiency (SANAA, ENEE, HONDUTEL); and
c) Deferring low priority investments (HONDUTEL).

B) Increase in Revenues:

- Adjustments in utility rates and user charges (SANAA, ENEE);

C) Improvement in services (ENEE, SANAA);

D) Refinancing of existing debt (ENEE); and

E) Further privatization and closure of public enterprises (CONADI, BANADESA, IHMA, BANASUPRO's distribution network, FNH, and COHBANA).

76. The introduction of the above-noted measures will likely reduce the reliance of public sector enterprises on the Central Government budget over the years. Hence, transfers to public sector enterprises such as INA and COHDEFOR could then be scaled down considerably, while the Government could begin to receive tax payments from HONDUTEL and the National Port Authority (ENP).

G.2. Institutional Links among the Central Government and Public Sector Enterprises

77. At present, the institutional links among the Central Government and public sector enterprises are quite weak. The legal framework for this link was first established in 1984 with the introduction of the law for financial adjustment of the public sector. This law led to the establishment of the Superintendency of Decentralized Institutions. The latter entity is responsible for monitoring the implementation of budgets of those institutions.

78. After its establishment, the Superintendency has begun to collect statistical information on the finances of public sector enterprises and to publish reports which indicate actual versus planned expenditures. As a result, the entity has only carried out clerical functions. It did not develop into a mature policy-oriented entity with a good overall view of finances of public sector enterprises; neither did it develop a good and usable statistical data base to judge the performance of public sector enterprises. Furthermore, it failed to obtain information on extra-budgetary outlays of enterprises and did not closely follow actual budget implementation. As a result, the supervision and monitoring of public sector enterprises by the Central Government has remained very weak.

79. Conclusions. There is an urgent need to strengthen the Superintendency both in terms of staff as well as its monitoring powers. Without such a strengthened entity within the Ministry of Finance, it would be an extremely difficult task to implement a tough fiscal package. However, improved monitoring of public sector enterprises should not conflict with the responsible and accountable management practices at the public enterprise level. It should lead to an improved two-way communication among the Central Government and public sector enterprises.

G.3. Privatization

80. To reduce the financial burden on the Central Government to own and to operate a multitude of public sector enterprises, there is a need for privatizing some entities and some services currently provided by those entities as well as to close down others. This would allow an increase both in allocative as well as in productive efficiency. It would also help the public sector to focus on high priority areas.

81. The Government has taken steps to privatize some public sector enterprises. The authorities have already sold some of the companies in CONADI's (public development bank) and COHDEFOR's portfolios and they intend to continue this process. Given the complexities involved in such operations, the process will likely be lengthy.

82. Issues faced in accelerating the privatization effort include:

(i) a cumbersome legal framework, which defines the rules under which privatization is to take place;

(ii) the absence of a truly committed political leader who can devote full time to the privatization effort; and

(iii) the absence of a well-established capital market in which assets of public sector enterprises are sold and transferred to the private sector.

The first issue identified above results in a lengthy process. The third issue results in the need to establish sale prices of enterprises--a difficult feat, given the conflicting objectives of trying to determine as high a price as possible to benefit from the sale (i.e. in terms of higher levels of revenues and political saleability) and of attempting to define as low a price as possible to ensure a sale.

83. Conclusions. To expedite the privatization effort, it is suggested that the Government designate a high level official who would be responsible for overseeing the whole operation, providing direction and guidance and top-level Government support. The current arrangement, with one high level official involved in privatization as well as in a multitude of other tasks, is inadequate. Regarding the cumbersome law which defines the privatization process, the suggestion is not to change it in the short-term, given the uncertainties involved in attempting to modify it under the present political atmosphere. Concerning the determination of a price at which enterprises will be sold to the private sector, it is important to note that the fiscal impact of the proposed privatization will not be significant in the short-term. However, a decrease in the size of the public sector would allow the Central Government to focus its attention on the issues it has to address and do a better job within the context of a reduced public sector. On the other hand, selling enterprises at a very low price (i.e. compared to their book values or current market values) would go against public sentiment and would likely make further efforts at privatization politically more difficult. Regarding the particular enterprises to be privatized or closed, it is suggested that the Government continue with the privatization effort for enterprises owned and operated by CONADI and COHDEFOR along the lines of its declared strategy. However,

it is important to include in the privatization program the following enterprises: BANADESA (National Agricultural Development Bank), IHMA (Agriculture Marketing Agency), and BANASUPRO's (Food Marketing Agency) distribution network. It is also suggested to close those enterprises for which the reason for their existence has disappeared (i.e. COHBANA--Banana Corporation) or a continued operation would imply high levels of Central Government transfers (i.e. CONADI). If priced to market, both domestic and foreign private sector would be interested in buying and operating the above-mentioned publicly owned enterprises.

G.4. National Electricity Company (ENEE)

84. ENEE faces a major financial problem in its overall finances, which are expected to worsen in the medium-term in the absence of corrective measures. The root cause of this financial crisis is the high installed electric power generation capacity, which is currently not being fully utilized and the mounting external debt service payments, which are expected to increase substantially in the next several years. The large increase in ENEE's installed capacity is associated with the lumpy investment project, El Cajon.

85. As described in other parts of the report, expenditures on El Cajon accounted for half of the public investment expenditures during 1981-85. Large external disbursements, including from IBRD and IDB, financed a significant part of the expenditures. The project was found to be the least cost alternative at the time of evaluation of different alternatives--including by the World Bank-- and its economic viability depended on expectations of buoyant domestic and regional markets. However, as both of these markets grew slower than predicted and some CACM members began to experience financial difficulties, ENEE's revenues did not materialize as expected. On the other hand, cost overruns on El Cajon project occurred and debt service obligations started to pressure ENEE's finances. The company's operations resulted in increased deficits of an annual average of ₡230 million during 1982-86. With hindsight, it is not clear whether or to what extent the company's finances would have been helped by higher levels of domestic and regional demand than those experienced so far. It is possible that even with a higher level of economic activity than experienced so far, ENEE's revenues would still have failed to meet contractual debt service payments in the next several years.

86. Based on ENEE's own financial projections and the present structure of its external debt, the company will not be able to service its contractual debt service obligations at least until mid-1990s. Without refinancing of external debt obligations, ENEE will be insolvent, thus adversely affecting the country's debt repayment capacity.

87. Regarding its tariff levels, ENEE did not modify them for several years, allowing it to decline in real terms. Based on long-run marginal costs and at the official exchange rate, however, the present level of electricity tariffs does not seem to be too much out of line.

88. Conclusions. In view of the magnitude of the financial disequilibrium faced by ENEE, however, electricity tariffs need to be raised to cover part of the financial needs of the company. Additionally, the company must intensify its revenue collection efforts. If the needed

adjustments are not introduced by the company and the required refinancing is not provided, then the Central Government has to introduce a stronger adjustment package, including additional revenue increases and expenditure reductions. As explained in the section on Central Government finances, the scope for a strong fiscal adjustment is probably not likely in the next several years, pointing out the need to introduce measures at the company level. Exports of electricity to neighboring countries on a cash payment basis would obviously ease the financial situation only if the regional outlook improves.

89. Concerning expenditures, there is scope for reducing current expenditures through the introduction of efficiency measures on a limited scale. Regarding investment expenditures, however, a well-thought-out program has to be prepared to enable ENEE to expand the distribution of electricity in the country. The entity is also suffering from the inadequate planning of transmission of the electricity network, which should in fact have been designed and put into implementation along with the El Cajon project.

G.5. National Agricultural Development Bank (BANADESA)

90. BANADESA is a Government-owned Bank with a branch network of 33 agencies. At end-1986, the book value of BANADESA's assets was t574 million (US$287 million) and outstanding loans equalled t300 million (US$150 million), of which over 75% were credits to the rural sector. The entity channeled credit to cooperatives of the reformed sector in agriculture. It also lends to small farmers, mostly producing basic grains. Loans for the livestock sector rose from 34.5% in 1980 to 45.8% in 1986.

91. Political interventions and directed lending in the past resulted in a large share of BANADESA's portfolio falling into arrears. These financial difficulties of the entity does not permit increased lending for agriculture in the next few years. In fact, BANADESA is requesting an injection of capital from the Central Government. However, unless the present policies of BANADESA are modified--an unlikely event in the short-term--the entity will likely require continued injection of capital in the future. Given the need to increase public savings, further capital injections will likely postpone the day of reckoning. BANADESA has tried many times, in the past, to introduce corrective measures to recover its portfolio in arrears, with no concrete result to date.

92. Conclusions. If politically viable, BANADESA needs to be closed down. Continued operation of the entity will not be profitable. Closing it will likely prove to be difficult, given the political sensitivities involved. To facilitate the process of closure, assuming that the authorities choose to do so, they should address the issue of channelling credit to the agriculture sector. One option would be to open a window at the Central Bank to provide agricultural credit.

G.6. National Industrial Development Corporation (CONADI)

93. CONADI is a public development Bank established to encourage the development of the industrial sector in Honduras. It has investments in

about 60 firms. These ventures account for about half of the private investment in Honduras. These firms are in sectors as diverse as in food, cement, sugar, chemicals, and wood. About one-third of these enterprises are not in operation. Four companies did not start operations and 17 closed down after being in operation for some time. Those that still operate have a reported capacity utilization rate of only 30%-40%. Virtually all of these enterprises have faced and are still confronting financial difficulties. As a result, CONADI's liabilities are now well over its assets. The Government has started a serious investment program by which it intends to sell or close down all companies owned by CONADI. It has also assumed the repayment of the entity's large debt service to external creditors since 1980. In the future, the company intends to continue to sell companies in its portfolio. On the negative side, the Government prepared a new draft law, which would maintain CONADI's previous development banking role. The above-mentioned draft law, if enacted, would likely be a repetition of the old mistakes. Given the country's precarious financial situation, there is no more scope for repeating the same mistake.

94. Conclusions. It is suggested that the Government continue with the proposed privatization of CONADI's companies. It is also suggested that it give serious consideration to not proceeding with the above-noted draft law, which would maintain CONADI's development banking role, and close CONADI.

G.7. Honduran Telecommunications Company (HONDUTEL)

95. HONDUTEL owns, operates, and invests in telecommunications in Honduras. Its operations have produced small surpluses in the recent past. However, the company is burdened by overstaffing, administrative problems, inefficient operations and the lack of adequate enforcement of revenue collection.

96. Conclusions. It is suggested that a number of measures be introduced to increase HONDUTEL's overall financial surplus to enable the company to transfer resources to the Central Government. In view of the already high domestic telecommunication charges, especially to overseas, increasing them is not suggested. Hence, the adjustment effort has to focus on: (i) reducing excess employment; (ii) raising efficiency in operations; (iii) enforcing collection; and (iv) decelerating the execution of projects to the extent possible, given that a lower priority has to be attached to further development of the telecommunications sector compared to other sectors, given the severe financial difficulties the country faces at this point in time.

G.8. National Water and Sewerage Service Company (SANAA)

97. SANAA is responsible for providing water in Honduras. It faces a huge task in expanding the network for water provision, since about half of the population is without safe water. About 80% of households in Tegucigalpa receive water and about 60% of households in urban and semi-urban areas are connected to piped-water. However, SANAA does not provide drinking water to areas where the population does not exceed 500.

98. SANAA has relied, in the past, on external financing and large Central Government transfers to finance its investment program. Its user charges have covered only part of the operating costs, with debt service payments being assumed in most cases by the Central Government. The company also faces problems because of its lax collection policies. To

expand the provision of water both to the metropolitan Tegucigalpa area and to the rural sector, SANAA intends to start 3 new projects, costing about US$120 million and complete them by 1990. These projects will be financed by the Inter-American Development Bank (IDB) as well as by transfers from the Central Government, which will also assume the repayment of debt service. SANAA has expressed its intention to increase its tariffs with the objective of covering 15% of the expected capital expenditures in the next several years.

99. Conclusions. Because of the planned ambitious investment program, SANAA can not be expected to implement any more projects until 1990. Moreover, given its precarious finances, it will also need to continue to rely on Central Government transfers to fund its investments. However, user charges will need to be increased, perhaps more than planned, to finance a larger share of the entity's planned investment expenditures as well as to tighten collection procedures to reduce dependence on Central Government transfers, given the need to reduce the fiscal deficit.

G.9. National Port Authority (ENP)

100. There are five ports in the country. Those include four ports on the Atlantic Coast: Puerto Cortez, Tela, La Ceiba, and Castilla. On the Pacific side, there is a deepwater anchorage at Amapala on El Tigre island and a mainland port at San Lorenzo. ENP operates all ports in the country. After some deterioration, ENP's operations began to produce a small surplus in the last few years. Being relatively more efficient and handling the bulk of the port services in the country, Puerto Cortez's operations resulted in large financial surpluses, covering the combined deficits of the other ports. Owing to reduced economic activity, all ports presently have excess capacity.

101. The level and structure of port user charges present difficulties in judging their adequacy. First, tariffs are subject to a very complex set of regulations, rendering them difficult to compare with rates with those of other ports in the region. Second, a study conducted a couple of years ago concluded that the incidence of port charges was not significant in total costs of various product categories. Third, a comparison of relative port charges should take into account relative efficiencies of ports concerned. It is believed that Puerto Cortez is much more efficient in handling cargo than most other ports in Central America. As a result, prima facie, it is not possible to conclude that port charges are high in Honduras or that they reduce profitability in exporting.

102. Conclusions. It is suggested that a thorough analysis of port user charges and costs be undertaken to simplify the rate structure and to introduce the needed changes, taking into account both the financial needs of the Port Authority and the need to avoid unnecessarily increasing charges for trade activities. Assuming that the trade levels would increase as a result of recovery of economic activity under the implementation of adjustment measures, port revenues would also likely expand. If current expenditures are not allowed to increase significantly, ENP's overall surplus will also likely rise. In view of the adequacy of port facilities for the next several years, no major investment will be needed to expand the port facilities in the country. It is, therefore,

suggested that ENP transfer part of its projected financial surpluses to the Central Government. In fact, since ENP is not exempt from taxes by law, no legal changes would be necessary to achieve this objective.

G.10. National Railway of Honduras (FNH)

103. The railway system operated by FNH consists of three narrow gauge railways in the north, with 992 km. serving primarily the banana plantations in the Sula Valley and the northern coastal strip. It also transports sawn timber and agricultural imports and exports. In the recent past, the entity incurred small financial losses, financed by Central Government transfers. Although the lines serving primarily the banana plantations should, in principle, be more economic vis-a-vis the highway network, it is not clear whether the continued operation of the system as a whole or those lines which are not serving the captive banana trade are still economic. The company also suffers from labor problems, inefficiencies in operations which translate into high operating costs as well as reduced volume of operations, reflecting both the problems faced by the real economy as well as shifting of some consumers into highway traffic.

104. FNH also has a very weak management. Despite the reduced volume and bleak prospects for recovery of transport volume in the short-term, the company's management has been considering a very ambitious investment program, including setting up a new line which would connect the Atlantic and Pacific Coasts as an alternative transport mode to the Panama Canal.

105. Conclusions. To improve the financial performance of the entity, it is suggested that efficiency-improving and cost-cutting measures be introduced. There is also a need to strengthen the management practices to improve services. A short and quick study might be useful to determine the economic viability of the railway system to prepare recommendations on the fate of the company. It is possible that a gradual phase-out could be planned based on such a study. Perhaps, only those lines which are economically feasible and serving the captive banana plantations could still be maintained. With respect to the investment program, it is essential to keep future investments in railways to basic minimum maintenance.

G.11. Honduran Agricultural Marketing Institute (IHMA)

106. IHMA was established by the Government to stabilize basic grains prices and ensure self-sufficiency in food. Despite these intentions and setting high producer prices, IHMA has not been able to achieve both of its objectives. Prices have fluctuated and Honduras still imports part of its food supply. The pursuance of the above-noted objectives, however, resulted in financial losses, subsidized by the Central Government. It also increased relative profitability of basic grains, in which the country does not seem to have a comparative advantage vis-a-vis export crops, in which the country seems to enjoy a comparative advantage. These policies also entailed implementation of import controls and hence in the disassociation of domestic food prices from international ones. In fact, in the recent past, producer prices set by IHMA have remained above both international prices and domestic selling prices. They have also exceeded other domestic producer prices. Another issue concerns the discriminating way by which IHMA selects farmers from whom it purchases grains. Since,

IHMA's purchases cover only one-tenth of domestic production in each crop, it selects the farmers from whom to buy based on very discriminating criteria, resulting in an income transfer from the public coffers to a selected few who have arbitrary access to IHMA. Having a small share in the market, IHMA's impact on setting producer prices has also remained relatively weak.

107. Conclusions. To reduce the financial drain on the Central Government of food subsidies, and begin to send appropriate signals in the direction of improved export profitability rather than encouraging basic grains, this report suggests that IHMA's operations either be phased out or the company be privatized. Obviously, given the political sensitivities and strong vested interests involved, this action could not be taken immediately. However, if closure or privatization options are not politically feasible in the short-term, this report suggests that the company's operations be gradually phased out. To cushion the impact on the poor farmers--to the extent poor farmers are affected by these changes--the Government may wish to consider targeting food subsidies to the needy farmers. It is also suggested that the Government phase out its role in setting basic grains prices and permit importation of food at tariff rates within the context of its overall tariff rate structure.

G.12. National Food Marketing Agency (BANASUPRO)

108. BANASUPRO is charged with regulating consumer prices for basic goods, mostly food items, as well as making those goods available to the public through its outlets in the country. It generally buys basic grains from IHMA. Following the financial deterioration of its outlets, the company decided to privatize some of them, which have now been transformed into profitable ventures.

109. Conclusions. It is suggested that all BANASUPRO's outlets be privatized over a number of years within a well-defined medium-term program. Furthermore, the authorities are well advised to seriously consider phasing out setting consumer prices.

G.13. Honduran Forestry Development Corporation (COHDEFOR) and Honduran Banana Corporation (COHBANA)

110. COHDEFOR was set up to ensure the management and regulation of forests in the country. It, however, engaged in commercialization of wood products and diluted its focus on forest management. It owned and operated a number of enterprises, which faced losses and liquidity problems. To reverse the financial deterioration, the authorities started a process of privatization and sold some of the enterprises owned by the company.

111. COHBANA was established by the Government to rehabilitate banana plantations following the damage caused by the Fifi hurricane. After successfully carrying out this important task, however, the entity lost its reason for its existence as the production of bananas is being handled by large multinational corporations.

112. Conclusions. It is suggested that the authorities continue the privatization of COHDEFOR's portfolio of investments. It is also suggested that COHDEFOR focus its attention on forest management and not be allowed to reenter the commercialization of wood products in the future.

G.14. Honduran Coffee Institute (IHCAFE)

113. IHCAFE is in charge of providing technical assistance, credit and infrastructure to coffee farmers. It undertakes investments in road construction in coffee growing areas. In addition, IHCAFE introduced programs to control the coffee rust disease, improve coffee yields and encourage crop diversification. Its revenues are derived from a share from the sale of coffee. In 1988, Congress reduced the share to be allocated to IHCAFE from the sale of coffee because of producer pressures.

114. Major issues regarding IHCAFE include a smaller share of its personnel engaged in direct extension services compared to a larger group at the headquarters, continued changes in the rules of the game for the commercialization of coffee, which the entity defines each year, leading to increased uncertainty for the private sector. The results have been reflected in a lack of success in combating the coffee rust disease, despite the high overhead costs, which have become difficult to finance in a sound manner.

115. Conclusions. It is imperative that the entity restructure its operations, devote a large share of its personnel to extension to help the coffee growers effectively prevent the coffee rust disease. The entity should not change the rules of the game for commercialization of coffee each year to be able to gain the confidence of farmers. It should not undertake road investments, as this activity should be carried out by the Ministry of Public Works. IHCAFE should begin to operate more efficiently with reduced financial resources.

G.15. National Agrarian Institute (INA)

116. INA was established to be the principal instrument in promoting rural land redistribution. However, the entity did not develop into a strong institution. Few professionals on its large staff, duplications in functions among various units and administrative problems hindered INA in achieving its original purpose successfully. In the past, it relied on external financial assistance and large Central Government transfers for financial survival. In fact, it has become one of the principal users of Central Government transfers in the last couple of years.

117. Conclusions. It is suggested that INA's scale of operations be substantially reduced, its employment decreased and the efficiency of its management be enhanced to levels consistent with tight public finances and increased delivery of its services to farmers.

G.16. Central Bank

118. Central Bank finances need to be reviewed thoroughly to determine whether it has incurred quasi-fiscal losses. It does not seem likely that the Central Bank operations have produced losses. Given the quality of the Central Bank's assets, however, it is likely that part of its portfolio may have doubtful economic value. For example, most loans to BANADESA and CORFINA may not be recoverable. Furthermore, adequate provisions for these likely losses have not been made. However, the Central Bank has not yet realized an explicit loss on its claims to these institutions.

119. Conclusion. There is a need to review Central Bank accounts to see what impact, if any, the above-mentioned assets would have on the quality of its assets as well as make adequate provisions, if required, based on such a review.

H. Overall Conclusions

120. Although, in theory, there is an innumerable number of options available to the authorities to address their fiscal issues, the final package would likely include a combination of reductions in expenditures and increases in revenues. In the final analysis, the political feasibility of actions (i.e. expenditure reductions and tax increases) would determine the final package. The preferred package is obviously one which would involve more expenditure reductions than revenue increases. But the final package could include more revenue increases than expenditure reductions, if reducing expenditures does not prove to be politically viable. In the short term, the Central Government will need to undertake the largest share in adjustment. In the medium-term, however, with the introduction of modernization measures and the rationalization of public investment program, more actions should be undertaken by public sector enterprises.

H.1. The Main Thrust of a Proposed Action Program

121. The World Bank could help the Honduran Government in implementing its policy reforms in the public sector through a public sector management operation. The main thrust of the reforms should include the following:

(i) modernizing the administration of the public sector;
(ii) increasing public sector savings from 0.4% of GDP in 1987 to about 4% - 5% of GDP by 1991;
(iii) ensuring the financial viability of ENEE; and
(iv) implementing a growth-oriented, financially viable pubic investment program.

122. The objectives of a plan to improve public sector management should include: increasing efficiency of resource use, rationalizing public sector operations, and reducing financial disequilibrium. Toward these ends, the authorities should focus on preparing and implementing an action plan to:

(i) increase savings;
(ii) introduce efficiency-increasing measures;
(iii) improve service delivery;
(iv) improve the budgeting process;

(v) implement a well-defined privatization program, including closures and transferring the provision of some public services to the private sector;
(vi) establish financial targets for public sector enterprises and reduce Central Government transfers to public sector enterprises;
(vii) improve the administration of tax collection;
(viii) prepare and implement a growth-oriented and financially feasible public investment program;
(ix) improve debt management;
(x) improve decision-making at the public enterprise level, giving managerial autonomy and accountability to managements of those enterprises;
(xi) standardize accounting practices and properly account for debt service obligations;
(xii) start external management audits of enterprises;
(xiii) improve coordination in the sector;
(xiv) target subsidies; and
(xv) produce timely and analytically-oriented financial information on the public sector.

H.2. Proposed Package of Measures to Reduce the Fiscal Deficit

123. Apart from the need to introduce measures to modernize the public sector finances in Honduras, there is also the urgent need to reduce the fiscal deficit. Implementation of actions listed below would reduce the fiscal deficit in the short-term: (i) an increase in the sales tax rate; (ii) introduction of a selective consumption tax; (iii) reinstating taxation on coffee exports; (iv) reduction of exemptions under imports; (v) increasing tariffs and user charges; (vi) decreasing current expenditures (i.e. reducing or slowing down expenditures on goods and services as well as on wages and salaries through the implementation of a freeze and a reduction in public employment--mostly through attrition); and (vii) deferring some low priority investments.

H.3. Risks Of The Suggested Package of Measures

124. The program is not riskless. Both external and domestic factors could adversely affect the program. On the external side, unforeseen developments on the Nicaragua border, deterioration in the terms of trade (i.e. a decline in the international price of coffee and bananas and an increase in the oil price) could adversely affect the macro outlook, and hence fiscal outcomes. Domestically, a number of issues could pose a threat to the program. First, political consensus--needed to implement the program--may not develop as expected. Second, a critical number of measures (i.e. changes in the tax rates, adjustments in utility prices) will depend on Congressional approval, which may not materialize. Third, unions in Honduras are powerful and they will likely resist reductions in employment and a continued freeze or a decrease in salaries. The teacher unions are especially powerful and they would likely protest a freeze on their salaries. Fourth, obvious short-term costs resulting from the implementation of the stabilization program (i.e. increased unemployment, possible reductions in real per capita consumption levels) could make it difficult for the authorities to fully implement the program. Fifth, the

timing of the implementation of specific measures would likely be as important as the package of measures. Finally, fiscal adjustment could depress GDP growth and could force the authorities to abandon the program. Therefore, the program needs to be kept flexible and public investment expenditures--financed by increased savings and external financing which would be obtained from official agencies, mostly at concessional terms--increased to counteract the possible recessionary impact of the fiscal adjustment measures.

H.4. Conclusion

125. Modernization efforts should not necessarily lead to increased savings immediately, but they will surely have a positive payoff in the medium to long-term in encouraging savings. Any serious effort at strengthening public finances should include efforts to restructure ENEE's external debt obligations. If the suggestions of this report are translated into timely action, they would help reduce the public sector deficit and hence would have a favorable impact on the balance of payments and increase savings. The rationalization measures would also help the public sector focus its attention on the most critical areas and improve service delivery and address deep-seated poverty issues.

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